

## **UKRAINE**

### **USAID ASSISTANCE IN FISCAL REFORM: FISCAL DECENTRALIZATION IN UKRAINE**

#### **I. PROJECT DATA**

**Level of Funding:** Undetermined, as Fiscal Decentralization was a small component of a Macroeconomic and Fiscal Reform project with an overall cost of \$24 million.

**Period of Assistance:** 1997-2004

**Types of Assistance:**

1. Technical Assistance
2. Training

**Areas of Assistance:**

Intergovernmental Fiscal System

1. Expenditure Assignment
2. Revenue Assignment
3. Formula-Based Transfer System

**Main Counterparts:**

1. Parliamentary Budget Committee and Sub-Committee on Local Government (including successive chairpersons and vice chairpersons)
2. Ministry of Finance:  
Director, Budget Department (including successive heads of Department of Territorial Budgets)

#### **II. THE PROJECT: BACKGROUND, PRINCIPAL RESULTS AND IMPACT**

##### *A. Background and Context of the Project*

Fiscal decentralization in Ukraine has occurred in the broader context of general fiscal reform and intergovernmental fiscal reform that, after being discussed since 1992, began to stir in 1998 and reached its pinnacle with the legislative adoption of a new Budget Code on March 22, 2001. The events and activities that shaped this reform process are described below beginning with a statement of USAID's reform expectations.

The USAID mandate - Task 8 of LRFP Omnibus II, Activity C:

“Assist in establishing a more rational and transparent system of intergovernmental finance, including defining the spending responsibilities and revenue raising authority of various levels of government and, as feasible, assisting lower levels of government to establish reasonable budget and tax administration systems.”

To carry out this mandate, USAID sponsored activity centered on assisting the Government of Ukraine to realize the three most important tasks of intergovernmental reform: (i) Achieving a rational, and stable, set of expenditure assignments among different levels of government; (ii) Securing a rational, and stable, distribution of revenue powers among different levels of government; and (iii) Designing and implementing a formula-based system of intergovernmental transfer payments. Progress and initial conditions in each of these three critical policy areas is discussed next.

## *B. Outcomes and Impacts in the Project's Principal Areas of Assistance*

### 1. Achieving a Rational Pattern of Expenditure Assignments

Since independence Ukraine's budgetary system had been plagued by the absence of clear-cut rules for determining the structure of expenditure responsibilities between State and local budgets. A 1991 Budget Law governed inter-budgetary relationships but it was obsolete and more appropriate for a country with a command economy than one transitioning to a market economy. Considerable ambiguity surrounded the question of which level of government should do what. For example, more and more responsibility for social protection spending was shifted from the State budget to local budgets without a corresponding shift of revenue resources to finance these additional expenditures. Not surprisingly, it was in this area that large local expenditure arrears appeared.

Under USAID auspices, a number of papers were prepared and circulated among policymakers making the case that social protection was properly a State budget responsibility and that Ukraine desperately needed legislation clarifying the expenditure assignments of both State and local levels of government. At the same time, USAID-sponsored work continued on the draft Budget Code that was adopted by the Verkhovna Rada on first reading in May 1999. This work attempted to set forth a rational set of expenditure assignments for State, oblast, city, rayon and town and village budgets based on the principle that any budget should encompass only those activities whose benefits accrue within its geographic boundaries. For example, regional oblasts should be asked to undertake only those expenditures that provide benefits primarily to their own residents.

A working group, sponsored jointly by the USAID-funded fiscal reform project and the World Bank, was created comprising members of the Verkhovna Rada budget committee and officials from the Ministry of Finance. After many meetings this group produced a document that explicitly and comprehensively defined a sensible set of expenditure

responsibilities for all levels of government in Ukraine. No longer, for example, would local kindergartens be funded in part from the State (central) budget if this document became law.

The output of this working group was enshrined in a revised Budget Code that received second reading approval from the Verkhovna Rada in early June 2000. Realizing that it had the strong political support of both the Verkhovna Rada and the Cabinet of Ministers, the Ministry of Finance courageously decided to formulate the intergovernmental portion of the 2001 State budget as if the Budget Code were the law of the land. Annex 5 of the 2001 State budget codified the set of expenditure assignments that were included in the revised Budget Code. In conformity with the provisions of this Code, the 2001 State budget also transferred responsibility for financing most elements of social protection back to the State budget. According to article 49 of this budget subsidies for communal services and energy consumption would be paid out of local budgets but would be financed entirely from targeted subsidies provided through the State budget.

## 2. Achieving a Rational Allocation of Revenue Powers

After independence, Ukraine exhibited marked instability in the distribution of revenue authorities between the State and local budgets. In the early 1990s all major taxes were shared at variable rates that tended to change from one year to the next. In 1996 the value-added tax, however, became an exclusive revenue source for the State budget and has remained so ever since. In 1997 and 1998 proceeds from all income taxes imposed on individuals and businesses were assigned to local budgets and the constitutional requirement of having separate revenue sources for State and local budgets was closer to being realized. However, in 1999 variable sharing rates for all income taxes were reintroduced. In the subsequent two years tax separation was restored. In 2000 and 2001 revenues from the enterprise profits tax (except from the Republic of Crimea and the city of Kiev) were directed to the State budget while revenues from the personal income tax became the major revenue source for local budgets.

The USAID fiscal reform project had produced a paper, and publicized it at several high-profile seminars, stressing that the personal income tax, because it came closest to being a tax on local residents, was the most suitable choice for a major local revenue source. From the array of available tax instruments, only the personal income tax was capable of forging a strong accountability link between the taxes paid by local residents and the local public services supplied to them. This view was incorporated into the revised Budget Code and reflected in both the 2000 and 2001 State budgets. In both the Code and these two budgets revenues from the enterprise profits tax and excise taxes were assigned exclusively, and appropriately, to the State budget. For local budgets a significant measure of revenue stability and predictability finally had been attained.

But the revised Budget Code went even further and partitioned the entire range of local government revenue sources into two revenue baskets, one that was relevant for purposes

of calculating equalization transfers and another that was not. The land tax, a form of property taxation, became the dominant revenue element in the latter revenue basket. The personal income tax, because its per capita yield varied widely among different cities and rayons, was included in the first revenue basket used to determine equalization transfers.

### 3. Achieving a Formula-Based Transfer System

From independence through the 1990s, transfers between higher and lower level budgets had been made on a subjective and highly nontransparent basis. Transfer entitlements and obligations of lower level budgets became negotiated items in a murky bargaining atmosphere that took place behind closed doors. In the 1990s Ukraine attempted to maintain the Soviet model of budgeting in which transfers were calculated as the difference between expenditure needs, based on the use of detailed expenditure norms, and revenues from shared taxes. However, with a sagging economy and a shrinking revenue base Ukraine could no longer afford the level of public services it previously enjoyed and a growing gap emerged between the norm-based expenditure requests of sub-national governments and the revenue capacity to satisfy them. As a result of this gap, limited budgetary resources were rationed among sub-national governments in a general climate of budget bargaining which robbed Ukraine of any semblance of budgetary transparency.

Transfers also operated on a hierarchical basis, flowing first from the State budget to oblast budgets and from there to city and rayon budgets and finally from the rayon budget to its constituent towns, villages and settlements. This hierarchical transfer system existed because oblast budgets were subordinate to the State budget, city and rayon budgets were subordinate to the oblast budget, and town and village budgets were subordinate to the rayon budget. This system of nested budgets was known as the budgetary “matroshka” after the famous Russian dolls that fit one inside the other.

The sequential nature of this transfer process also produced serious delays in the adoption of lower level budgets and effectively impeded sound local budget preparation and execution. As the byproduct of the budgetary bargaining process, these negotiated transfers were also inimical to good budgetary practices. Incentives to economize on expenditure and raise additional revenue were eroded because any benefits from these actions could be, and often were, cancelled through a compensating adjustment in the amount of the transfer a local government either made or received. To obtain greater objectivity and transparency in determining transfer levels, and to instill proper budgetary incentives at the local government level, a formula based transfer system was required that would realize these important objectives and equitably allocate budgetary resources among local governments.

The USAID fiscal reform project did much of the early spadework in preparing the policy ground for the introduction of a formula based transfer system. Several papers were produced describing the essential design features and requirements for a formula that

would be workable in the context of economic conditions in Ukraine. Local government databases were developed and used to simulate the likely impacts of introducing a formula based transfer system. The structure of the formula and the results of the simulation exercises were widely discussed with officials of the Ministry of Finance.

The virtues of adopting a formula based transfer system in calculating State budget transfers to oblasts was appreciated by the budget department of the Ministry of Finance and was a central feature of the initial draft budget for 1999. Unfortunately, this measure was labeled as premature by senior Ministry officials and was subsequently withdrawn.

Nonetheless, one important policy message did get through in 1999. To ensure the timely delivery of transfers, even if they were not formula-determined, and to bolster local incentives to collect State revenues, a method of daily deductions for financing the State transfer was proposed and accepted by the MOF. Under this method, a fraction of State revenues collected in a region would be transferred directly to the regional budget on a daily basis. The fraction in each case was the ratio of the amount of the budgeted transfer to the forecast of annual State revenue collection in a region.

Although this rejection of the formula approach in 1999 represented a policy defeat, formula ideas were gathering strength in other quarters. One of the key structural elements of the formula that had been proposed, the index of relative fiscal capacity, survived and was included in the Verkhovna Rada's budget resolution for 2000. This index was used to determine the revenue side of oblast budgets in the 2000 State budget and was subsequently incorporated into the new Budget Code.

Moreover, by early 2000 the working group dedicated to revising the Budget Code had completed its task and the major ingredients of a formula-based transfer system were included in the intergovernmental portion of the revised Code. The rest is history. This revised Budget Code was passed on second reading in May of 2000 and was used, albeit in a somewhat imperfect fashion, as the foundation for preparing the local government portion of the 2001 State budget. The third, and final, reading approval of the new Budget Code occurred on March 22, 2001. Fiscal Year 2002 marked the first year of the full implementation of the Code's formula provisions.

Ukraine's new equalization formula addresses both horizontal and vertical fiscal imbalances and calculates positive, and negative, transfers as the difference between estimated expenditure needs and estimated revenue capacity. This new formula strengthens all of the areas in which the former Ukrainian grant system was weak. Because the transfers are unconditional they preserve local fiscal autonomy and they create a more predictable revenue environment in which local governments can plan and execute their budgets. The formula also does not discourage local revenue raising efforts and is relatively immune from strategic manipulation and grantsmanship. While the formula is based on objective fiscal criteria such as population size, it is, however, not as transparent a mechanism for transferring funds to, or from, local governments as it might

be. The problem lies in the cumbersome methodology the Ukrainian government elected to use for determining expenditure needs. The formula could be simplified and made more transparent if this methodology were streamlined.

The new Budget Code also introduced a new and important facet of fiscal decentralization in Ukraine. Under its provisions, oblast level governments simply became another form of local government having their own unique expenditure responsibilities and revenue sources. As a result, city and rayon budgets that were previously controlled by the oblast budget were completely removed from the fiscal clasp of the oblast budget. Oblast, city and rayon budgets became autonomous budget entities linked only to the State budget through the new formula based transfer system. For the most part, the budgetary “matroshka” had been laid to rest. The only part of it that survived concerned inter-budgetary relationships inside the rayon and, even here, the Budget Code set out a clear timetable and framework for the development of an intra-rayon transfer formula.

Intergovernmental reforms in the new Budget Code facilitated fiscal decentralization in other ways as well. Along with the dismantling of the “matroshka” system, clear assignment of both revenue resources and expenditure powers and use of a formula for determining transfers now enables local governments to more effectively plan and execute their budgets. Clarity and stability in expenditure responsibilities and revenue powers, combined with much greater transparency in calculating transfers also enhance local budgetary accountability and that implies greater budgetary sensitivity to local voters’ needs and wishes.

With the adoption of the Budget Code local governments also possess a relatively high degree of expenditure autonomy. It is worth emphasizing that, under the formula, local budgets with the same estimated expenditure needs will enjoy the same expenditure opportunities, or potential, but how they exercise that potential is to a large extent a matter for local decision-making. If, for example, an oblast, city or rayon government wishes to spend a little more, or less, on health care than the formula-determined amount of health expenditure, that is its prerogative. Finally, it is also worth noting that fiscal decentralization in Ukraine was accompanied by desirable recentralization of the responsibility for social protection.

What is still missing from the decentralization picture in Ukraine is access to a significant revenue source over which local governments have control of the base, the rate or both. Without such access, local governments lack the revenue flexibility to be wholly responsive to their constituents’ expenditure needs. There have been attempts to introduce both a local property tax and local surcharges on the personal income tax but thus far none of these efforts have come to fruition. Nor have they attracted donor attention.

### **III. FACTORS OF SUCCESS**

Several factors can be identified as having an important influence on Ukraine's progress toward realizing a more decentralized fiscal system and a more rational and effective set of intergovernmental fiscal relationships. Two in particular are discussed here: the role of USAID technical assistance to the reform process, and the role of the Fiscal Analysis Office (FAO) in helping to lay down some of the important planks in the reform platform.

1. The Reform Role of USAID. USAID support for fiscal decentralization and intergovernmental fiscal reform had a number of different dimensions including the following:

- (a) Support for a broad reform strategy. In its initial stages this strategy involved documenting the failings and shortcomings of the existing intergovernmental system in Ukraine, shining light on the most promising reform options and gaining the attention of policymakers who would act on the reform advice that was offered.
- (b) Support for an effective strategic intervention in the reform process in the form of a newly created Fiscal Analysis Office intended to spearhead this process. The specific contributions of this Office are separately discussed below.
- (c) A commitment to a sustained reform effort. It would have been easy, and perhaps natural, for USAID to have withdrawn its support in 1999 after the failed attempt to implement a formula-based transfer system. But instead of perceiving this failure as an irrefutable signal that Ukraine was not ripe for reform of this type, USAID wisely chose to stay the course and, within a year, the seeds of reform that had been sown earlier began to bear fruit.
- (d) USAID provided support for enhancing public awareness about the nature and importance of the intergovernmental fiscal system and this initiative helped both to build greater consensus for the reforms and to dissolve political opposition to them.
- (e) USAID supported work for the initial monitoring of the reform's impact on different local governments and helped to allay some initial fears that some local governments would be significantly worse off as a result of these reforms.
- (f) Another aspect of USAID support came in the form of funding for the training of local government officials on how to apply properly the provisions of the new Budget Code. This type of support helped to insure that the reforms were successfully implemented at the local level.

Perhaps two key features of USAID's support for reform deserve further emphasis because, without either one, the reforms that were realized would have been placed in considerable jeopardy. First, the support provided by USAID was comprehensive in nature covering everything from initial conception of what reforms were required to their ultimate implementation. No significant part of the reform process was overlooked.

Secondly, the long-term nature of the complicated reform process was recognized and no pressure was exerted on contractors to come up with unrealistic reform results in the short run. In the case of intergovernmental reform in Ukraine, a period of five years was required to yield significant reform progress.

2. The Role of the Fiscal Analysis Office. Although originally conceived of as an embryonic budget office that eventually would be grafted institutionally onto the Verkhovna Rada, the FAO quickly became engaged in the process of intergovernmental fiscal reform. After it was established in March of 1998 the FAO forged a close working relationship with the Rada's budget committee and with the budget department of the Ministry of Finance. The impetus for the FAO's early involvement in the reform process arose from a marriage between the budget committee's interest in developing a new Budget Code and the technical expertise the FAO could offer to this committee. This marriage produced a clearly defined reform mission and focus for the activities of the FAO which enabled it to perform multiple policy functions:

- a) In part because its staff consisted almost exclusively of local budgetary experts, the FAO was widely perceived as a local institution. This perception allowed the FAO to become the main vehicle for policy dialogue among all of the prominent players in the reform process. Meetings of the working group, described earlier, regularly took place within the confines of the FAO.
- (b) Because it became a focal point for reform discussion and debate, the FAO was instrumental in building consensus around the most appropriate direction for reform and in creating a sense of local ownership of these reforms.
- (c) The FAO was also important in providing a venue for achieving coordination among different donors who were promoting the reform process. Besides USAID, other major stakeholders involved in this process were the World Bank and the LARGIS project sponsored by DFID.
- (d) The FAO was also a proficient research unit that continuously monitored the execution of State and local budgets, analyzed State budget proposals and conducted independent research on how to best structure a formula-based transfer system. The results of this research activity were disseminated in two publicly available forms, in a quarterly bulletin with a readership of over 2,000, including all members of the Verkhovna Rada, and on a user-friendly web site.
- (e) After the Ministry of Finance decided to partially implement the Budget Code reforms in the 2001 State budget, the FAO launched a nation-wide public information program using all available media to enhance public awareness about the nature and importance of these reforms.
- (f) The final contribution of the FAO to the reform process was its participation in a national training program to educate and familiarize local government budgetary officials on how these reforms should be deployed at the local level.

3. Local Ownership of the Reform Process. Creating local ownership of any reform is of crucial policy importance. Without local ownership it is next to impossible to engage the



local political and policymaking process in supporting the reform. In the absence of that support reform efforts will inevitably fail. Successful reforms require strong local champions. However, building such local ownership takes time, considerable effort and perhaps even a little luck. Trust and confidence in the views and advice offered by a technical assistance project, and thus the willingness to effectively utilize that project's resources, seldom spring up overnight.

In the case of Ukraine, the process of securing local ownership had a number of key ingredients. Early on, the project, more specifically the Fiscal Analysis Office, was successful in enlisting the support and cooperation of key counterparts, in particular influential members of the Verkhovna Rada's budget committee who carried considerable political weight and were committed to budgetary reform. This core support provided a critical mass that attracted important officials from the Ministry of Finance into the reform fold who did not want to be left out of the reform discussions and were seeking to have some impact on the reform outcomes that they would ultimately have to implement. The role played by foreign advisors was also a factor in building local ownership. While these advisors were responsible for shaping the content and direction of the decentralization reforms, the marketing of these reforms was left largely in the hands of a highly competent local project official who could more easily interact with key counterparts. Local ownership appears easier to nurture if foreign advisors guide the reform process and avoid the perception of trying to drive it.